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BC

FRDA REPORT 060

THE HEALTH OF THE BRITISH COLUMBIA SAWMILL INDUSTRY

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INTRODUCTION

There is a considerable amount of conflicting information provided regarding the health of the BC sawmilling industry. Any financial data published suggests that the forest industry, as a whole, is producing record profits. Yet the great majority of sawmills are either part of an integrated company or are private companies. The results for the former are heavily influenced by pulp and paper profits and the latter do not publish information.

In the following report a number of different criteria have been used in isolation to judge whether the industry appears to be healthy or not. Particular attention has been given to recent developments in order to see whether any specific impact can be discerned relative to the imposition of the 15% export duty in 1987 and its subsequent replacement with higher stumpage and silvicultural costs.

The analysis has been undertaken on a totally objective basis using only published data. The opinions of industry were not sought since it was felt that these could well introduce a subjective element. It is possible, however, that a more broadly based study, including confidential interviews with companies in different parts of the province, operating under different conditions and serving different markets, would provide a clearer disaggregated picture of the current health of the industry.

ANALYSIS OF INDUSTRY HEALTH

Financial Results

The only two publicly quoted companies with only sawmills are Slocan and Primex. In addition Doman and International Forest Products can be included in spite of their involvement in pulp through Western Forest Products due to their method of accounting. The published financial results show the following quarterly earnings:

Table 1
Quarterly Earnings
($000)

		Primex	Slocan	Interfor	Doman
1986	1Q	310	1,300	2,900	1,900
	2Q	145	2,900	4,600	7,100
	3Q	505	1,300	1,100	7,600
	4Q	645	2,200	2,700	6,100
Total		**1,605**	**7,700**	**11,300**	22,500
1987	1Q	505	2,600	3,000	3,800
	2Q	435	2,900	3,200	5,500
	3Q	1,065	3,400	7,100	9,600
	4Q	975	2,900	7,800	6,000
Total		**3,000**	**11,900**	**21,100**	24,900
1988	1Q	570	3,500	4,700	8,000
	2Q	530	3,200	100	6,200
	3Q	-220	2,700	-1,700	9,500

The results of all these companies demonstrate good growth up to the latter part of 1987. In 1988, however, the situation changed except for Doman and, to some extent, Slocan. The earnings have declined significantly.

Unfortunately neither Primex nor Slocan is really representative of the BC sawmill industry. Primex operates entirely on the Coast and is dependent on the vagaries of the Vancouver Log Market for its raw material. VLM prices increased at the time that stumpage levels increased but the escalation was much greater than warranted simply by stumpage. During 1988, however, prices dropped again and are currently at or below the levels that existed prior to stumpage increases. It is apparent therefore that supply/ demand movements are of greater significance than the stumpage aspect. In addition, Primex was exempted from the 15% export duty and a significant part of its income is generated by further processing.

Slocan is also somewhat atypical though less so than Primex. Its operations do not include the Northern Interior region where stumpage increases were much greater than the average for the Interior and do include areas where the high costs of logging and relatively poor quality timber reduced the impact of stumpage under the new policy.

The remaining two companies, Interfor and Doman, are essentially coastal operations (except for one Interior sawmill). Though both these companies have an involvement with pulp mills through Western Forest Products it is understood that the financial impact is not reflected to any extent in the statement of net earnings. The earnings levels for Interfor are influenced in 1986 by some extraordinary earnings due to earlier tax losses but the overall trends are essentially an increase in 1987 followed by a decline in 1988. The company is largely involved in the offshore export market therefore the 15% export duty to the US would have had a limited impact. However, increased stumpage and silvicultural costs no doubt influence 1988 results. In addition there have been ongoing problems related to the start-up of the new Linck sawmill.

The results for Doman are somewhat different. Indeed, the operations of the company differ significantly from those of the industry norm. The mills are entirely on the Coast yet a significant proportion of production is destined for the US market. Consequently, the impact of the export duty was significant and reduced the 1987 improvement (compared with Interfor). The corollary, however, was that the company benefitted from the new stumpage policy (compared with Interior producers) since coastal stumpage increases were less than those in the Interior and may have been less than the amount paid as export duty.

On the basis of just these four companies it would appear that the health of the industry was reasonably strong in 1987 but is currently in a state of decline. These specific companies are not, however, necessarily representative of all sawmills. It is also worth noting that even in the strong year of 1987 net earnings represented significantly less than 10% of total sales. This level cannot be regarded as a very comfortable margin.

Capital Expenditure

Information on capital expenditure is recorded on a regular basis by Statistics Canada. This information also incudes a statement of intentions for the next year. The information for the years 1978-1988 is shown in Table 2. These figures are for capital expenditure and exclude expenditure on repairs. It should also be noted that the figures include all wood industries. The impact of sectors other than sawmilling would not, however, be very significant.

The substantial fluctuation over the 10-year period are very evident. The industry reduced spending radically in 1983 but were at a relatively low level throughout the period 1982-1986. The decline in expenditure is even more noticeable when the expenditures are converted to constant 1980 dollars. Expenditure prior to 1982 had been averaging at around $260 million (1980$) and dropped to an average of a little over $100 million (1980$) for the five-year period 1982/86. The amount spent in 1987 returned expenditures to earlier levels but the 'intention' for 1988 is considerably in excess. The amount identified as "intention" is based on revised information obtained between the end of April 1988 and the beginning of July 1988. Analysis of past statistics shows that there is a very close correlation between these revised intentions and actual expenditure.

Table 2
Capital Expenditure
BC Wood Industry
(million $)

	Current $	Constant 1980$
1978	197.8	241.22
79	254.2	282.44
1980	290.9	290.90
81	260.6	234.77
82	134.5	111.16
83	78.9	62.62
84	161.9	124.54
1985	138.6	103.43
86	189.7	137.46
87	369.5	256.60
88	580.5	387.00

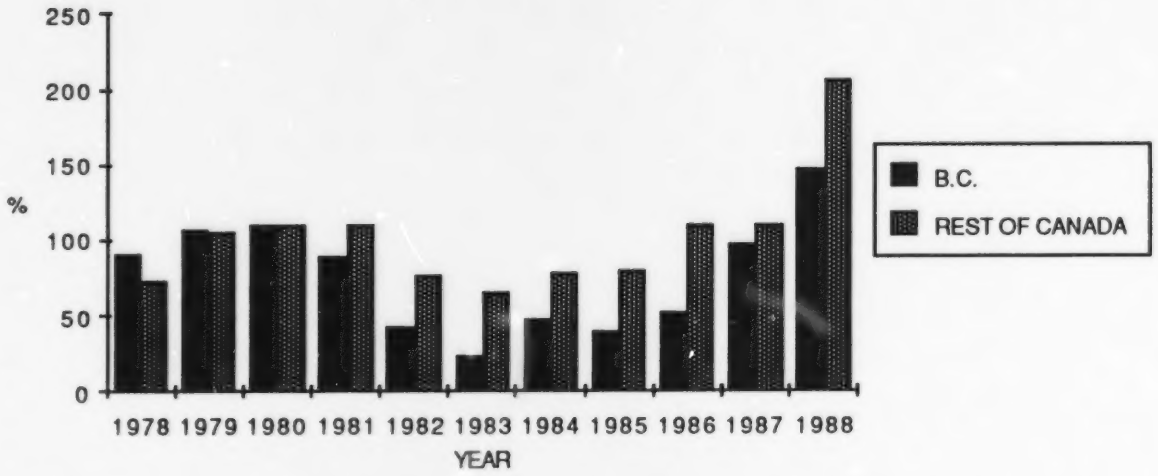
The high level shown for 1988 is particularly impressive since it does not include any major items such as had been evident in the previous year (e.g. the Linck sawmills at Carnaby and New Westminster and the OSB plant at Dawson Creek).

If the health of the industry is to be judged solely on the basis of capital expenditure it could be concluded that the industry has recovered well from an unhealthy period in the mid 1980s. It can be argued that 1987 and perhaps part of 1988 expenditure results from decisions taken prior to the imposition of the export duty/stumpage. Even so, it is clear that 1988 expenditure is likely to be significant.

A comparison with activity in the sawmill sector in other provinces is shown in Figure 1. The expenditures are shown on an index basis where the average for each region during 1978-1981 is taken as 100. From this figure it is apparent that there was a much greater decline in the mid 1980s in BC than in the other provinces.

Furthermore, the 1988 recovery in the rest of Canada has been significantly greater than in BC.

Figure 1
Sawmill Capital Expenditure
B.C. vs Rest of Canada
(1978-1981 average = 100)



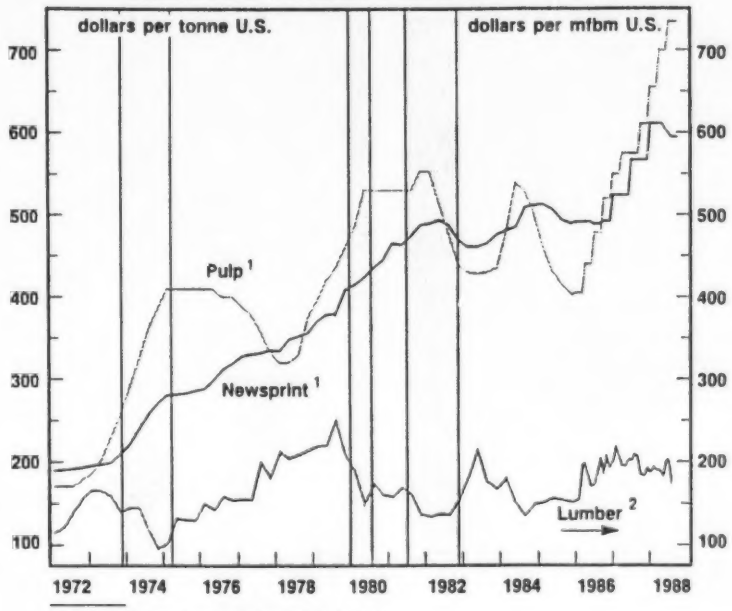
There is the strong possibility that a significant part of the recent modernization is more a reflection of previous low spending levels than just an indication of current health. Consequently, on the basis of a comparison with the rest of Canada, the BC industry appears far from healthy.

Prices

A possible criterion by which to judge the health of the industry is on price. Here, any comparison with the pulp and paper industry demonstrates that the sawmilling industry is faced with significant problems. A recent analysis by Scotia Bank provided a dramatic illustration of these problems. Selected forest product prices were charted for the period 1972 to 1988 (Figure 2). Whereas, up to 1979 there was a reasonable relationship, in the last ten years pulp and newsprint prices have risen while lumber prices have fluctuated around a relatively static trend.

Figure 2

SELECTED FOREST PRODUCT PRICES



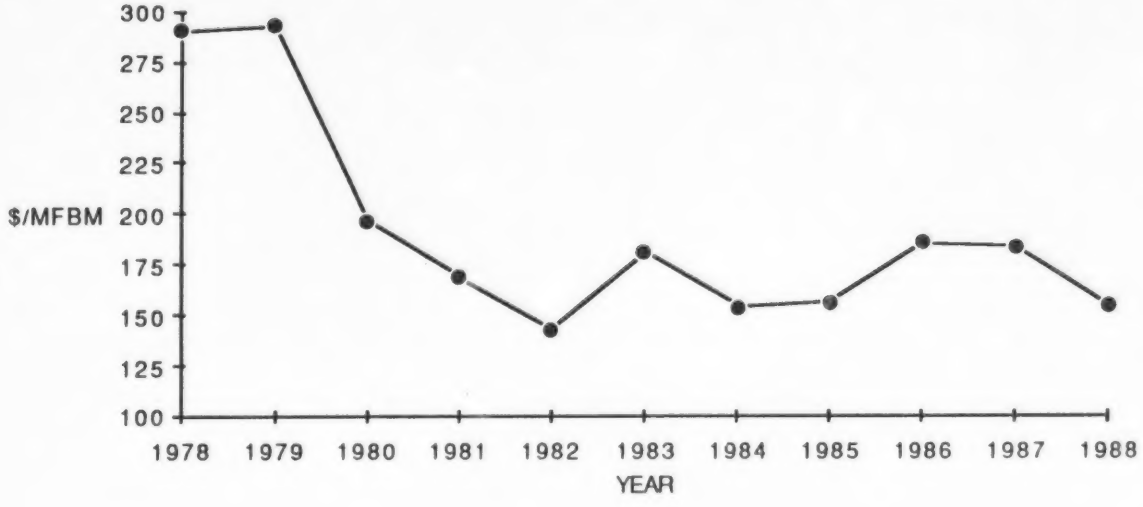
1. Newsprint and pulp delivered to U.S.A.
2. Western S.P.F. 2x4 lumber.
- Quarterly 1972 to 1985; monthly from January 1986.
- Shaded areas represent U.S. recession periods.

Scotiabank Economics

These figures are shown in current US dollars.

The BC sawmills incur virtually all their costs in Canadian dollars and most of these costs are inflation linked. The price movements in terms of constant Canadian dollars therefore provide a more realistic indication of the health of the industry. Price trends on this basis are shown in Figure 3.

Figure 3
CANADIAN LUMBER PRICES
(constant $ 1980)



Since the precipitous fall in price in 1980 the levels show a slow decline. It is particularly interesting to observe the lack of any direct relationship between market prices and what occurred regarding export duty or stumpage. The prices in 1987 were almost exactly the same as those in 1986 on average; yet the mills had to pay 15% export duty. In 1988, when, on average in the Interior, mills were incurring significantly increased costs in terms of stumpage and silviculture (even compared with the 15% duty) constant Canadian dollar returns went down by $30/MFBM.

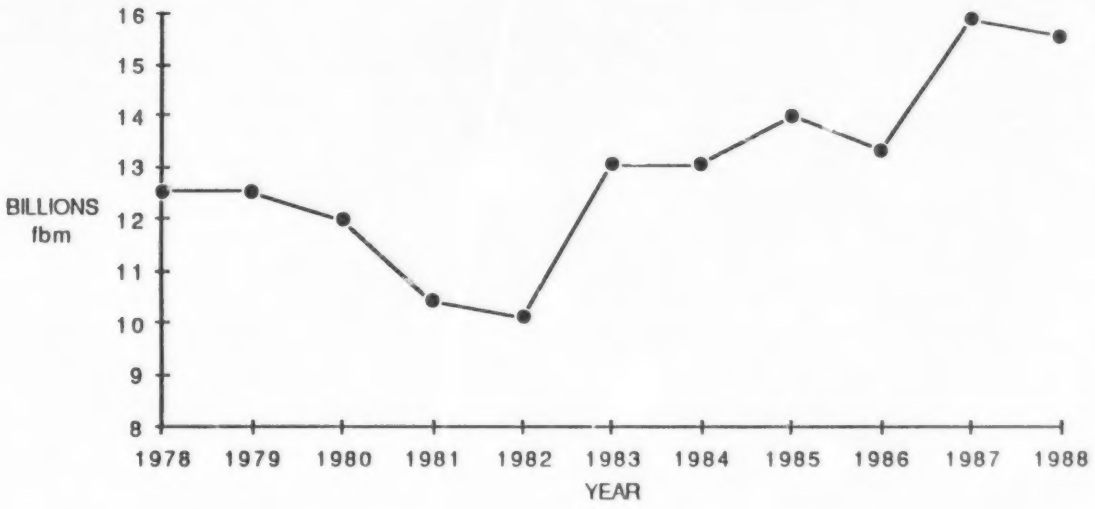
There are two basic causes for this lack of relationship. The first is that lumber market prices are not (except in very poor markets) responsive to costs. The second is that the Canadian dollar increased in value in 1988 but US market price levels totally ignore exchange rates.

If price movements are used as an indicator of industry health the conclusion that must be drawn is that the industry is in considerable trouble. Over time, the impact of modernization and improvements can counteract a gradual price decline but there is little doubt that the 1988 drop in price must have a serious effect on profitability, particularly when the increased cost burdens for the raw material in 1988 are taken into consideration.

Volumes

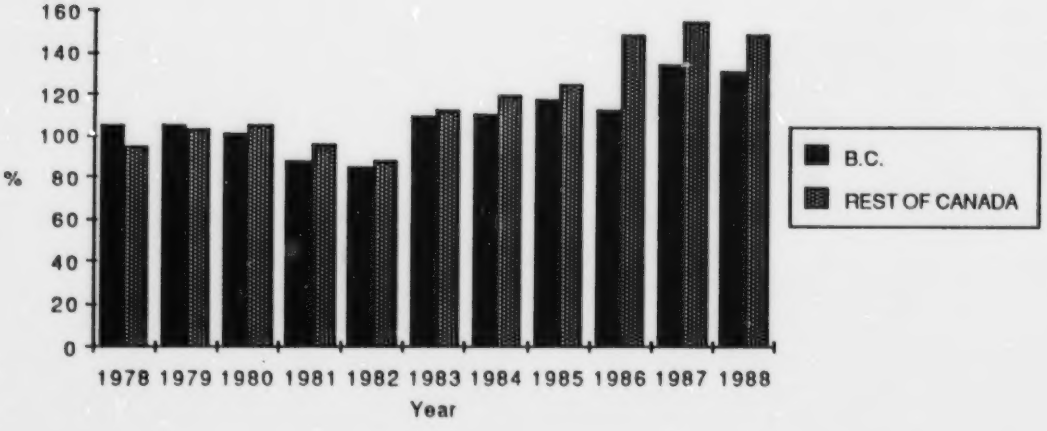
A logical parameter on which to judge industry health is production volume. As can be seen from Figure 4 these volumes have increased substantially since 1978. Production in 1987 reached a record volume and was close to 20% higher than 1986. The level in 1988 is expected to be close to this record volume.

Figure 4
B.C LUMBER PRODUCTION



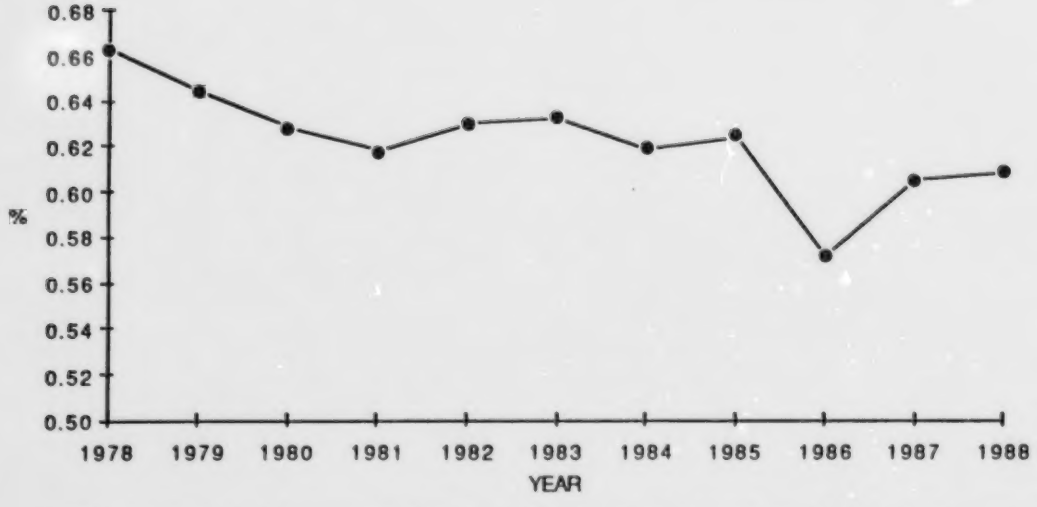
On the basis of volume, therefore, the industry would appear to be extremely healthy. However, since production volume is very much a function of market demand, it is worthwhile comparing the performance of BC with that of the other regions in Canada. This comparison is shown in Figure 5. The average production for the years 1978-1981 has been used as an index and the performance of the two regions are compared. It is evident that, though BC production levels show increases, the other provinces have performed much better.

Figure 5
Lumber Production Volume
B.C. vs Rest of Canada
(1978-1981=100)



Consequently, using volume as the criterion for health, it can be judged that the BC industry has benefited from strong markets but has lost market share (Figure 6). It is interesting to note, however, that in 1987 and 1988 the BC position has improved.

Figure 6
B.C. SHARE OF CANADIAN LUMBER PRODUCTION



This change could suggest that the mills in Ontario and Quebec now face greater limitations to short term growth than is apparent in BC, where the 1987 harvest reached 90 million m^3.

CONCLUSIONS

It is apparent that the results from analysis of each of the four criteria are somewhat mixed.

- **Financial Performance.** The four companies appear to have shown considerable strength in 1987 but the results for 1988 show a significant decline in earnings.

- **Capital Expenditure.** Expenditure on modernization returned to normal levels in 1987 and are likely to be high in 1988. However, long term analysis has shown that capital expenditure usually lags industry profitability by a year. Furthermore the BC sawmill industry has been spending considerably less on a proportionate basis than other Canadian regions.

- **Prices.** Lumber price performance is a disaster compared with pulp and paper. Furthermore, 1988 returns have dropped substantially, due to the exchange rate, in spite of increased wood costs.

- **Volumes.** The amount of lumber produced in 1987 and 1988 was at record volumes. However, the long term trend indicates that the BC sawmill industry is slowly losing its predominant share of total Canadian production.

The overall conclusions is that, though the BC sawmill industry recovered in the mid 1980s from a disastrous few years, its current state of health is one of decline. Increased wood costs and a strong Canadian dollar are the immediate concerns, but there is also the fear that both the North American and offshore markets are due to be depressed in the near future. There does not, however, appear to be any objective evidence, on the basis of the parameters analyzed, to indicate that the 15% export duty had a significantly negative impact on the industry in 1987. Nevertheless, it is likely that the health of the industry in that year would have been even better without the duty.